TESTIMONY OF
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DAVIS POLK & WARDWELL LLP
ON BEHALF OF THE
SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE

HEARING ON
THE OVER-THE-COUNTER DERIVATIVES MARKETS ACT OF 2009

SEPTEMBER 17, 2009

Chairman Peterson, Ranking Member Lucas, and members of the Committee:

My name is Dan Budofsky. I am a partner of the law firm Davis Polk & Wardwell LLP. I am appearing today on behalf of the Securities Industry and Financial Markets Association ("SIFMA")[1] and its members. Thank you for your invitation to testify today.

The membership of SIFMA is diverse and includes financial firms of different sizes as well as firms that are active in different parts of the financial services business. Although my testimony today is being presented on behalf of financial services firms, it also is focused on the interests and concerns of those firms' customers, the thousands of American corporations that benefit directly from the

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 650 securities firms, banks and asset managers locally and globally through offices in New York, Washington, DC, and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. Fundamental to achieving this mission is earning, inspiring and upholding the public's trust in the industry and the markets. (More information about SIFMA is available at http://www.sifma.org.)

broad availability of derivatives transactions to manage various risks that arise in connection with their day-to-day business activities. These companies also benefit indirectly from the availability of over-the-counter derivatives (OTC derivatives) such as credit default swaps, which make credit more readily available to them and at lower cost because it permits those who extend credit to those companies to hedge their risks as well. SIFMA's members have built successful derivatives businesses by offering products that meet important needs of their customers, and it is in their interest to support legislative and regulatory measures that will improve the integrity, soundness and efficiency of the OTC derivatives markets on which their businesses are based. Such measures serve the interests of all market participants - the dealers and their customers - and the American public, as well.

Indeed, fifteen major OTC derivatives dealers, in a recent letter to the Federal Reserve Bank of New York, committed to clear 90% of all new eligible interest rate derivatives and 95% of all new credit default swaps through centralized counterparties by December and October 2009, respectively. This, along with working with lawmakers and regulators, will help achieve the laudable goals of increasing regulatory transparency and reducing systemic risk in the OTC derivatives market.

At the same time, SIFMA's members are concerned about legislative proposals that would unnecessarily diminish the usefulness of available derivatives or limit the availability of useful derivatives by imposing significant new costs or limitations in connection with their use.

There is much in the Over-the-Counter Derivatives Markets Act of 2009 (the "Act") that SIFMA and its members support. In particular, SIFMA supports legislative proposals to ensure that systemically significant derivatives dealers are subject to comprehensive regulatory oversight. The lack of meaningful regulation of AIG's derivatives affiliate allowed poor business practices to go unchecked and ended in a situation in which the federal government had to invest tens of billions of dollars in that enterprise. Legislation that implements comprehensive regulatory oversight of systemically significant firms would address this regulatory gap.

SIFMA also supports measures that will improve regulatory transparency and thereby facilitate oversight of derivatives markets and the activities of individual market participants. The Act would accomplish this by requiring that swaps either be cleared through a derivatives clearing organization (a "DCO") (in fact, if they are *standardized* they would be required to be cleared through a DCO) or be reported on a post-trade basis to a swap repository or the CFTC. Similar requirements, including reporting to the SEC, would be imposed under the Act with respect to security-based swaps. SIFMA believes that by combining regulatory transparency with oversight of systemically important firms, the Act addresses the regulatory shortcomings that allowed the AIG situation to threaten the global financial system.

The Act goes much further than this and, in so doing, could adversely affect the availability and usefulness of derivatives transactions. I will briefly describe several of the issues in the Act that SIFMA has identified as particularly problematic.

The Act mandates that all swaps that are standardized be traded on an exchange or an alternative swap execution facility. SIFMA believes that the legislation incorrectly views transparency and risk reduction as being achievable solely through exchange trading, but these goals can be achieved through other means. SIFMA does not believe there is any reason for the government to mandate that business be transacted in this particular manner. In the equity markets we have both exchange trading and over-the-counter trading. The policy goals of transparency and systemic risk reduction are achieved by timely post-trade price reporting and clearance of transactions effected by broker-dealers through registered clearing agencies. It has long been recognized that while an exchange is a facility for transacting business that provides buyers and sellers with a place to meet, it is by no means the only way for transactions to occur. Highly liquid, frequently traded products may benefit from exchange trading, whereas it may be more appropriate for products that trade less frequently to trade over-the-counter. For example, the U.S. bond market is an overwhelmingly over-the-counter market, yet it is transparent and well-regulated. Bond transactions are reported to trade reporting facilities that make the execution prices available to regulators for surveillance purposes. Bonds clear through clearing agencies such as DTCC that provide a central counterparty, and this performs an essential risk mitigation function.

SIFMA also is concerned about the application of the Act's many regulatory provisions to the customers of derivatives dealers, the corporations that use derivatives. For example, the Act would effectively require corporate end users to become members of registered clearing agencies. Let me explain why. The Act includes an exception to the mandatory clearing requirement for standardized swaps in the case of transactions in which one of the parties is not a dealer or major swap participant (*i.e.*, is a corporate end user), but only if that party *also* does not meet the eligibility requirements of the clearinghouse. The definition of major swap participant is so broad and vague that it could easily include many corporate end users, and the eligibility requirements of clearinghouses will not necessarily constitute a significant hurdle, particularly insofar as they are profit-making entities eager to expand their businesses. If corporate end users were required to clear their standardized swaps they would incur the very significant cost of posting margin in the form of cash or cash equivalents, which is the form of collateral required by clearing agencies. Because these funds would no longer be available for productive investment in the corporate end user's business, a clearing requirement would create a significant disincentive to use swaps to manage risk. Today, in the OTC derivatives world, corporate end users may be required by their dealer counterparty to post margin, but that margin may be in the form of assets other than cash or cash equivalents.

Although CFTC Chairman Gary Gensler recently suggested in a letter to Members of Congress that end users could post margin in the form of assets other than cash, SIFMA does not believe that is a realistic or viable alternative, as it would expose the clearinghouse, which as the central counterparty must be highly liquid, to unacceptable levels of risk.

Another example of the Act's potential impact on end users arises in connection with margin requirements. Although regulators are not required to impose a margin requirement on end user transactions that are not cleared, the Act says they *may* do so, and *would be required to* if the end user falls within the definition of major swap participant *or* the transaction does not qualify for hedge accounting treatment under FAS 133. This means that an extension of credit created through a swap transaction must be collateralized, even though most other extensions of credit between the parties could be made on an unsecured basis.

In short, SIFMA does not believe that corporate end users, as opposed to professional market participants such as swap dealers, should be subject to burdensome new regulatory requirements in connection with their swap transactions. If they are, the result will likely be that they are exposed to more risk, not less.

SIFMA members also are concerned about the imposition of incremental capital requirements with respect to their cleared swaps. The clearing process makes these transactions less risky. Market participants benefit by gaining a well-capitalized clearinghouse as a counterparty and by the clearinghouse's requirement that all of its transactions be secured by margin. The addition of a further safeguard by imposing the requirement of additional capital for cleared transactions seems unnecessary, in particular because the cost of each of these layers of protection is directly borne by the dealers, and ultimately by their customers. Policymakers should be concerned about imposing a level of cost that discourages prudent risk management. Giving the CFTC, the SEC, and prudential regulators the general authority to establish capital requirements would seem to be sufficient.

SIFMA also has a practical concern about the short implementation time provided in the Act. Its provisions are to become effective 180 days after the date of enactment. SIFMA does not believe this would give derivatives dealers and other swap participants sufficient time to comply with the Act's complex and far-reaching provisions. SIFMA believes that the effective date should be no less than one year after the date of enactment.

In conclusion, Mr. Chairman, I would like to reiterate the support of SIFMA and its members for legislation to address weaknesses in the current regulatory framework for derivatives transactions. The events of the past year have made it clear that improvements are needed. However, derivatives have become an integral part of our economy and they play an important role in the risk management efforts of commercial companies across the country. As such, it is important that legislation intended to improve derivatives regulation and reduce systemic risk does not unnecessarily impair the usefulness of derivatives and thereby increase the risk exposure of the many companies that have come to depend on them.